Commercial Rent Control—a Bad Idea Then, and Now

The definition of "control" includes "to exercise restraint or direction" and "to hold in check." The Small Business Jobs Survival Act, also known as Intro 737, and often described as the "commercial rent control" proposal, was most recently proposed again about one year ago. Proponents of the legislation claim that "control" is a mischaracterization. However, the bill does seek to restrain, direct and hold in check what private property owners can do with their space and how much they can charge. It also contains mechanisms that will serve to exert downward pressure on the achievable rents for currently unencumbered spaces. That is, indeed, control.

This legislation is nothing new. Since ancient times, governments have been trying to set maximum or minimum prices. The Old Testament prohibited interest on loans, the maximum price of bread was fixed by medieval governments, and in more recent times, governments in the United States have fixed the price of gasoline, the minimum wage and something near and dear to our hearts, the rent on apartments in New York City, to name a few.

The appeal of price controls is understandable. Even though they fail to protect many consumers and hurt others through unintended consequences, controls hold out the promise of protecting groups that are particularly hard-pressed to meet price increases. However, the reason most economists are skeptical about price controls is that they almost always distort the allocation of resources. To paraphrase the perspective of the late American economist Milton Friedman, economists may not know much, but they do know how to produce a shortage or surplus. Price ceilings, which prevent prices from exceeding a certain maximum, cause shortages.

Robert Knakal.

To those of us in the New York City commercial real estate market, we observe firsthand the gross misallocation of our housing resources that residential rent regulation has on our marketplace. Elderly widows won't move out of a four-bedroom apartment and families of five remain in their one-bedroom regulated apartment. This dynamic constrains supply and exerts significant upward pressure on the stock of apartments that are not constrained by regulation.

From 1945 through 1963, the city had control over commercial rents and the idea has resurfaced many times since then. Political leader Ruth Messinger led a big push in 1986 and this legislation came closest to passing in 2009 when the initiative was sponsored by 32 of 51 members of the City Council. The most recent version has been sponsored by just 16 council members. However, this time around, the recent surge of radical elected officials has many in the industry concerned.

There are no construction jobs, no permanent jobs and no real estate tax revenue. This brilliant move has subsequently been called a "miscalculation" by several of those politicians I have spoken to directly.

In these same negative ways, Intro 737 seeks to create restrictive protections for commercial tenants. The proposal essentially forces a property owner to offer any non-residential tenant a 10-year renewal lease 180 days prior to the expiration of its lease. If the parties cannot agree on a new rent, a mediation process or binding arbitration kicks in. If the owner doesn't like the result of the arbitration, it's too bad. If the tenant doesn't like the result, it can ask for a renewal lease which is capped at 110 percent of the rent paid in the last year of the lease (it is not clear whether this includes pass-throughs for real estate tax escalations and operating expenses).

The owner can offer the space to the market and if that rent is more than the 110 percent increase, can proceed with that lease, but the old tenant has a first right of refusal to match the offer made by the third-party tenant. Because of the first right of refusal, the ability of an owner to get a fair market rent is encumbered. Does a letter of intent trigger the first right or does the owner have to produce a signed lease? If the latter, what prospective tenant is going to go through the lengthy and expensive process of negotiating a lease only to have the old tenant match its offer?

If the intent of Intro 737 is to insulate tenants from large rent increases, the legislation is off the mark. If the arbitration process is to produce a truly fair market rent, then the tenant gets no benefit, other than being able to match that rent, which presumably it might have been offered before the whole process began. However, proponents of the bill know that the proposed mechanism will not provide a truly fair market rent. Intro 737 is yet another gross miscalculation by legislators that could benefit from an Economics 101 class.